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(1)



# ***In the Supreme Court of the United States***

OCTOBER TERM, 1942

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No. 857

THE FRANCE STONE COMPANY, PETITIONER

*v.*

GUY T. HELVERING, COMMISSIONER OF INTERNAL  
REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED  
STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH  
CIRCUIT*

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**BRIEF FOR THE RESPONDENT IN OPPOSITION**

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## **OPINIONS BELOW**

The memorandum opinion of the United States Board of Tax Appeals (R. 93-98) is not officially reported. The Circuit Court of Appeals promulgated no formal opinion, but expressed its views in its judgment (R. 103-104), which is not reported.

## **JURISDICTION**

The judgment of the Circuit Court of Appeals was entered on February 9, 1943 (R. 103-104). The petition for a writ of certiorari was filed on

March 27, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended.

#### QUESTION PRESENTED

Whether taxpayer's preferred stock certificates constituted contracts prohibiting the payment of dividends within the meaning of Section 26 (c) (1) of the Revenue Act of 1936, so as to entitle it to a credit thereunder in computing its undistributed net income.

#### STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 10-15.

#### STATEMENT

The material facts as found by the Board of Tax Appeals (R. 93-97) from a stipulation by the parties (R. 26-29) may be summarized as follows:

Petitioner is an Ohio corporation with its principal place of business at Toledo. It is engaged in the business of crushing stone for railroad ballast, concrete construction, highway building, and similar uses. (R. 93.)

Early in 1933 petitioner's capital structure was revised, and thereafter was as follows (R. 94):

- 8,000 shares cumulative preferred stock—nonvoting;
- 10,000 shares class A common stock having a par value of \$100 per share and entitled to a dividend of \$6 per share per year—nonvoting;

10,000 shares no par value class B common stock which was voting stock. Stated value of the B stock was \$1,000.

The new preferred shares were represented by new certificates, and one of the provisions under which such new preferred shares were issued, and which appeared on the preferred stock certificates, was in part as follows (R. 94):

After providing for the payment of the cumulative dividend then due on the preferred shares, and before any dividends are declared, paid or set aside to or for other shareholders, the Directors shall set aside from the remaining surplus earnings for each year, a sum equal to five percent (5%) of the par value of all of the preferred shares then outstanding, as a Sinking Fund to be held and used for the redemption of the preferred shares as hereinafter provided, and for no other purpose. This Sinking Fund provision shall be cumulative so that if in any year, the surplus earnings of the corporation shall be insufficient for the purpose of setting aside the aforesaid amount so provided for sinking fund, then no dividend shall be paid to, or declared or set aside for, any shareholders other than the preferred shareholders.

Up to December 31, 1937, dividends were paid annually on the preferred shares. Dividends of 10 cents a share were paid on the class A common stock from 1931 through 1937, inclusive, since the petitioner desired to continue its dividend record,



having paid a dividend upon its common stock since its beginning. (R. 94-95.)

Petitioner sustained net losses for each of the years 1932 through 1935, and during that time made no provision for meeting its sinking-fund requirements with reference to the redemption of the preferred stock. During 1936 it made provision for increasing this sinking fund in the amount of \$63,000 and paid this amount to the trustee for redemption or retirement of its preferred stock. During 1937 petitioner increased this sinking fund in the amount of \$37,000. At the end of 1937 petitioner had outstanding \$700,000 par value of the 6% cumulative preferred stock. According to the revised articles of incorporation printed on the reverse side of its certificates of the preferred stock, the amounts required to be set aside as a sinking fund to be held and used for the redemption of the preferred stock aggregated \$385,000 to January 1, 1937. The amounts actually set aside for the fund up to that date amounted to \$263,000. The amount of \$37,000 added to the fund during 1937 brought the total amount actually set aside to \$300,000 as of December 31, 1937. (R. 95-97.)

Petitioner's balance sheet at the close of 1937 showed total assets of \$2,479,345.30, capital stock liabilities of \$1,701,000, and earned surplus of \$658,356.71 (R. 96-97).

On its return for 1937 the petitioner, in computing its undistributed profits surtax, claimed a

dividends paid credit of \$46,099.14 on account of dividends stated to have actually been paid in cash during the taxable year, and also claimed a credit for contracts restricting dividend payments in the amount of \$60,977.05, which was less than \$121,850, the cumulative deficiency in its sinking fund as of December 31, 1937. (R. 96.)

In the notice of deficiency the Commissioner allowed a dividends paid credit of \$44,807.50, which amount is equal to the cash dividends paid during the year 1937, and disallowed the amount of \$1,291.64, which represented a dividend carry-over from the preceding taxable year. The Commissioner also disallowed the claimed credit for contracts restricting dividend payments in the amount of \$60,977.05 (R. 96).

The petitioner reported a net income for 1937 of \$118,347.12. The Commissioner determined that the correct adjusted net income was in the amount of \$123,410.20. He also determined an adjusted net income for surtax computation in the amount of \$111,379.81, and an undistributed net income of \$66,572.31, which resulted in a surtax on undistributed net income of \$10,747.62, the amount of the deficiency in controversy (R. 96).

The Board of Tax Appeals sustained the Commissioner's determination of the deficiency, and held that petitioner's preferred stock certificates were not "contracts" within the meaning of Section 26 (c) (1) of the Revenue Act of 1936. The Circuit Court of Appeals for the Fifth Circuit

affirmed the judgment of the Board of Tax Appeals.

#### ARGUMENT

The court below ruled that petitioner was not entitled to the credit claimed because the preferred stock certificates were not "contracts" within the meaning of Section 26 (c) (1) of the Revenue Act of 1936. The court thus followed the view which it had previously expressed in *Warren Telephone Co. v. Commissioner*, 128 F. 2d 503, certiorari denied, No. 550, this Term, and *Metal Specialty Co. v. Commissioner*, 128 F. 2d 259,<sup>1</sup> that upon the general theory of *Helvering v. Northwest Steel Mills*, 311 U. S. 46, the word "contract" in Section 26 (c) (1) was intended to refer to ordinary contracts entered into by the corporation with its creditors, and not to internal agreements within the corporate framework such as those involved in the charter and stock certificates here. In reaching that result the court differed with *Lehigh Structural S. Co. v. Commissioner*, 127 F. 2d 67 (C. C. A. 3d), which held that such agreements were "contracts" within the meaning of Section 26 (c) (1).

The *Warren Telephone Co.* case was similarly in conflict with the *Lehigh* case, but this Court denied certiorari presumably on the ground sug-

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<sup>1</sup> See also *Bishop & Babcock Mfg. Co. v. Commissioner*, 133 F. 2d 199 (C. C. A. 6th).

gested by the Government that the decision was in any event correct for reasons unconnected with the issue in the *Lehigh* case. Similarly here, certiorari is not called for, since the decision reached below is clearly correct on grounds not touching the issue involved in the conflict with the *Lehigh* case. For even if the stock certificates be regarded as "contracts" within the meaning of Section 26 (c) (1), petitioner still would not be entitled to any credit under this section because the amount of dividends which it could have distributed during 1937 without violating those "contracts" exceeded its adjusted net income for that year. The preferred-stock certificates merely provided that before any dividends could be paid on any stock other than the preferred stock, a sum equal to five percent of the par value of the outstanding preferred stock should be set aside from the surplus earnings of each year. But petitioner's earned surplus at the end of 1937 amounted to \$658,356.71. Its adjusted net income for 1937 was \$111,379.81. The current preferred dividend requirement for 1937 had been paid, and even after deducting from petitioner's earned surplus the total cumulative arrearages in the sinking fund, amounting to \$121,850, there was a remaining surplus exceeding \$500,000 from which dividends might have been paid. The payment of such dividends would have entitled petitioner to a

dividends-paid credit under Section 27 (a). Failure to pay them was not mandatory under the "contracts," so the credit was not allowable.<sup>2</sup> Accordingly, the result below is correct irrespective of the issue whether the stock certificates are "contracts" within the meaning of Section 26 (c) (1).

Furthermore, the issue cannot arise for future tax years, and, in view of the relief provisions (retroactive to 1936) with respect to deficit corporations in the Revenue Act of 1942,<sup>3</sup> the question presented by the conflict with the *Lehigh* case may become moot in many of the pending cases.

#### CONCLUSION

The result reached by the court below is correct. The issue raised by petitioner presents no question of such general importance as would warrant

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<sup>2</sup> Surplus, as well as current earnings, are to be taken into account under the statute in determining the total amounts which can be distributed as dividends. *L. O. Koven & Brother, Inc. v. Commissioner*, 47 B. T. A. 467, 471, affirmed January 11, 1943 (C. C. A. 3d) (1943 C. C. H., par. 9244); *Trianon Hotel Co. v. Commissioner*, 44 B. T. A. 1073; *Monroe Abstract Corp. v. Commissioner*, 41 B. T. A. 5; see also *Central West Coal Co. v. Commissioner*, 44 B. T. A. 661, 669, affirmed, 132 F. 2d 190 (C. C. A. 7th).

<sup>3</sup> Section 501 (a) (3) of the Revenue Act of 1942, Public Law 753, 77th Cong., 2d Sess. (Appendix, *infra*, pp. 11-12) amends the Revenue Act of 1936 and allows additional credits in the case of deficit corporations. It in no wise affects the applicability of Section 26 (c) (1) of the Revenue Act of 1936 to nondeficit corporations, as in the case of petitioner here.

further review by this Court. We submit that the petition should be denied.

Respectfully submitted.

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